MARK CAMPBELL OF CLIFFORD CHANCE LLP DISCUSSES THE EFFECT OF CORPORATE COLLAPSES, SUCH AS THE LIKES OF ENRON AND WORLDCOM, ON THE ATTITUDES OF LENDERS.

THE FALLEN ANGEL SYNDROME

At a time when many companies, including some with relatively high credit ratings, have been facing severe financial difficulties, and the emphasis has been on restructurings, it is no surprise that one of the key developments in the syndicated loan market has been a greater focus on credit issues. In particular, this article focuses on, the continuing debate on structural subordination in senior/junior structures, the greater concentration on documentation issues, and the increasing importance of due diligence.

However, it is a fact that continuing competitive pressures among banks mean the focus on credit issues is not always being maintained.

THE FALLEN ANGELS

Before dealing with specific examples of the greater focus on credit, it is worth examining some of the general issues that have arisen from recent corporate collapses, since these tend to indicate the areas on which that greater focus will concentrate. Although economic cycles tend to mean that downturns are regular, and share many of the same characteristics, each downturn also tends to have its own particular flavour. This time, the most obvious difference is that many of the companies that got into difficulties have done so remarkably quickly, despite being considered strong credits by the markets – the Fallen Angel syndrome.

What are some of the reasons for this, and what particular concerns does it create? Let's explore the issues.

ACCOUNTING PRACTICES. One of the key reasons for the Fallen Angel syndrome has been that the accounting practices of some of these companies have been called into question. For many years they have been viewed as being very strong financially but this has been revealed to be an erroneous assumption, for example, Enron and WorldCom.

COVENANT PROTECTION. Such has been the bargaining power of many of these companies that, during the bull market which preceded the downturn, these borrowers were able to negotiate out of syndicated loan documentation many of the covenant protections that prudent lenders would usually be seeking. This has meant the early warnings provided by financial covenants, and the business restrictions provided by other restrictive covenants, such as restrictions on acquisitions, have not been present in syndicated loan documentation. Therefore, by the time the syndicated lenders have discovered the borrower's financial difficulties, the fall from 'angel' to 'devil' status is a rapid one.

One example of the syndrome is Marconi. The company was borrowing extremely successfully in the syndicated loan market only six months prior to the market's discovery that the loans were virtually worthless – and these loans were made with no financial covenants and virtually no restrictive covenant protections.

STRUCTURAL PROTECTION. Because most of these Fallen Angels were able to borrow on investment-grade terms, the care usually taken in non-investment grade credits to ensure structural priority for the lenders was not always taken – on the basis that the chances of a default within a short time frame were comparatively low. Again, Marconi is an example of this, as the lenders and bondholders were, unusually, on equal terms, which led to unique difficulties in restructuring the company's balance sheet.

DUE DILIGENCE. Significant due diligence was rarely carried out on any of these companies. Although it is arguable that conducting in-depth due diligence on Enron, for example, would have had little effect – given the web of complex schemes apparently designed to prevent anyone from seeing the true nature of the company's finances – it is certainly true that, when many of these companies were restructured, the due diligence carried out at the time of restructuring shows the lenders had little idea of the risks they were undertaking when agreeing the original transactions.

EXAMPLES OF GREATER FOCUS ON CREDIT

These characteristics of the collapse of the Fallen Angels have been followed by a greater focus among banks on certain credit aspects of new deals – a classic swing of the pendulum at this stage of the cycle.

STRUCTURAL SUBORDINATION. For some years, the issue of structural versus contractual subordination in more structured deals has been one that has been exercising the minds of senior lenders and high-yield investors, as well as their advisers. The way in which the importance of structural protections has been highlighted by some of the Fallen Angel cases has resulted in an increased concentration on this issue.

FIGURE 1
SENIOR/HIGH-YIELD STRUCTURE
(STRUCTURAL SUBORDINATION)

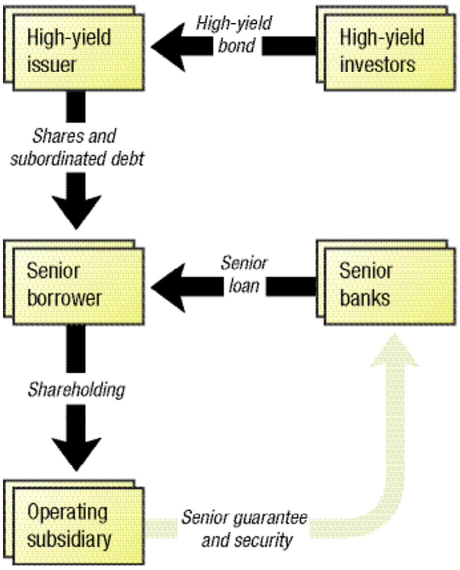
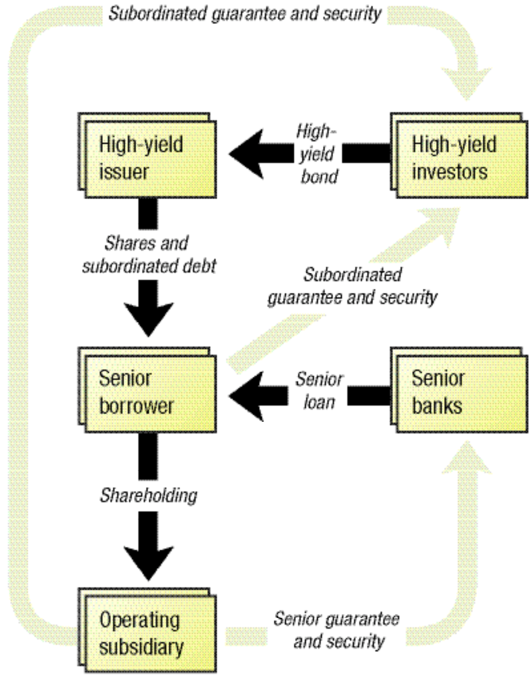


FIGURE 2
SENIOR/HIGH-YIELD STRUCTURE
(CONTRACTUAL SUBORDINATION ONLY)



In particular, senior lenders and high-yield investors have had to look at the structure of leveraged syndicated loan transactions (LBOs). The typical structure of these deals (see *Figure 1*) has been that the senior lenders have lent to a holding company – the senior borrower – and taken guarantees and security from that company and all the significant operating companies below it in the group structure. In many deals, high-yield investors have financed a holding company – the high-yield issuer – which is placed above the senior borrower in the structure and have not taken guarantees and security from operating companies.

In this way, the high-yield investors have been structurally subordinated, in that they have no claim against the borrower or guarantors under the senior loan. Consequently, if there is a default, the senior lenders can effectively deal with group companies ranking lower in the structure than the high-yield issuer, without having to refer to the high-yield investors.

For some time, high-yield investors have been seeking to improve their position in the structure of these transactions. Not only does structural subordination mean high-yield investors have next to no influence when the group gets into difficulties, but it also means they are subordinated to the claims of the unsecured creditors, such as trade creditors, of the group's operating companies, notwithstanding the significance to the group of the finance they provide. In effect, they are treated like providers of equity, but without the upside potential of a shareholder. As a result, high-yield investors have sought, at the minimum, a structure where they receive guarantees, secured or unsecured, from the operating companies, therefore putting them in a better position regarding the trade creditors, with the senior lenders obtaining their priority through a contractual subordination (see *Figure 2*).

Although there are a number of proponents of this approach in the market, and a number of transactions have now followed this structure, some senior lenders continue to view it with suspicion.

The key reason for this is a concern that, no matter what the strength of the contractual subordination, as soon as the high-yield investors are given guarantee claims against operating companies, they will have a seat at the table in any restructuring talks, and because of the nuisance value this gives them, they will be able to negotiate a better deal for themselves than their subordinate position would merit.

Issuers resist the giving of guarantees/security to the high-yield investors, because it results in a need to audit and disclose financial information in relation to all the operating companies, particularly where the transactions require SEC registration.

If senior lenders are to agree to the high-yield investors obtaining such guarantees/security, they will want the ability to ensure it is released in circumstances where, as part of the enforcement of the senior security, subsidiaries or assets are being sold, because a buyer will not want to buy subject to high-yield guarantee/security. This is an increasingly difficult area, as high-yield investors are seeking to impose a requirement that such a release should be dependent on a fair market valuation (FMV) certification being provided as to the sale price of the relevant asset.

Nonetheless, deals have been agreed by senior lenders that give high-yield investors some of the protections they seek, including the so-called Mezzanine Note Structures, and this is an area of continuing development.

DOCUMENTATION. As might be expected in the circumstances, there is some evidence that lenders are taking documentation more seriously in the aftermath of the various corporate collapses. In particular:

- there is a continued emphasis on underwriting risk – perhaps still at the expense of credit risk – emphasised by more attention being paid to mandate letters;
- there is a recognition that, in light of Enron-type accounting practices, it is not enough simply to rely on Generally Applied Accounting Principles (GAAP) in setting financial covenants, but that documentation protections against 'window dressing' should be included; and
- following the experience with Marconi, and other credits where the material adverse change (MAC) clause has been used, there is increasing recognition that MAC provisions can be part of the lenders' armoury of protection.

DUE DILIGENCE. We are likely to see more emphasis being placed on due diligence, although perhaps not in transactions for investment-grade borrowers, which is where most of the Fallen Angels were rated prior to their demise.

In particular, due diligence is being used extensively to check the availability of take-out finance, for example, by way of whole business securitisations, where the syndicated loan is effectively a bridge finance. However, there are limitations to the usefulness of due diligence. In particular:

- in many 'public-to-private' (public takeover) transactions, it is barely possible to do any; and
- financial due diligence, performed by accountancy firms, usually comes with significant limitations on responsibility and liability.

CONTINUING COMPETITIVE PRESSURES. In spite of this increased emphasis on credit and underwriting issues, it is clear lenders continue to be under intensive competitive pressures to complete transactions, which often result in credit standards being significantly lowered. One area where this is apparent is 'public-to-private' deals, many of which are carried out effectively as auctions, where lenders are pressured to provide unconditional finance with little due diligence.

KNOCK-ON EFFECT. Clearly, some of the recent corporate failures have hit some lenders very hard and caused some changes to their behaviour, which, temporarily at least, are having an effect on lenders' attitudes to the legal side of transactions – albeit that competitive pressures continue to affect the ability of lenders to insist upon protective measures.

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